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Disciplining Managers: Shareholder Cooperation in the Shadow of Shareholder Competition

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DISCIPLINING MANAGERS: SHAREHOLDER COOPERATION IN THE SHADOW OF SHAREHOLDER COMPETITION

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I. INTRODUCTION

Ironically, the greatest obstacle to a group's achievement of its goals is often its own constituency—the group members themselves. Individual interests bring members together and encourage them to act in pursuit of common objectives. These same interests, however, lay the seeds for apathy and opportunistic behavior, and in certain cases, provide the incentive for dissolution. Shareholders in a corporation have many interests in common, especially maximizing the return on their investments. Although they would benefit from acting in concert to monitor and discipline managers who run the corporation on their behalf, they often find it impossible to coordinate their actions enough to do so.[1]

[1] The question of shareholder apathy has been one of the principal questions in corporate law since the publication of Berle and Means's path-breaking 1932 book claiming that there existed a separation of ownership and control. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). The law responded to the problems raised by the separation of ownership and control in various ways. For example, Section 14 of the Securities Exchange Act of 1934 and the Proxy Rules adopted pursuant to that Section were meant, in part, to make it easier for shareholders to exercise their vote in an informed manner. 15 U.S.C. § 78m (1988 & Supp. V 1993); 17 C.F.R. § 240-14a (1994).

Until fairly recently, commentators assumed that shareholder passivity was a necessary by-product of the way large public corporations raised their equity capital and managed their operations.[2] Shareholder passivity was deemed rational because of the existence of a collective action problem in shareholder voting.[3] The collective action problem arises because although shareholders as a group would benefit from acting in concert to discipline managers, each individual shareholder has an interest in remaining passive in the hopes that she will benefit without cost from disciplining action taken by other shareholders.

More recently, commentators have focused on the possibility of circumventing this collective action problem.[4] This is because the last decade has

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[2] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402-03 (1983). Managers in large public corporations typically generate the information required to make corporate decisions. Thus, "it is unlikely that voters would think themselves able to decide issues for themselves with greater insight than the managers do. No wonder voters delegate extensively to managers and almost always endorse their decisions." *Id*; *see also* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301-02 (1983) (stating that organizations characterized by the separation of ownership and control survive because they separate ratification and monitoring of decisions from initiation and implementation of such decisions).

[3] For example, a shareholder who owns 5% of the stock of a corporation that she believes is being mismanaged can spend her own money to wage a proxy fight to replace the board of directors. While she bears the whole cost of waging the proxy fight, she only receives a 5% share of any increase in value of the corporation brought about by the change in the composition of the Board. More importantly, however, the other shareholders will receive 95% of the gains even though they did not contribute any funds toward meeting the expenses of the proxy fight. The gain in corporate value is a collective good to be shared pro rata by all of the shareholders. As a result, no one shareholder has an incentive to incur all of the expenses necessary to carry out the proxy fight. Instead, each shareholder likely will decide to wait and take a free ride on the actions of other shareholders, with the end result being that no shareholder takes any action. *See* MANCUR OLSON JR., THE LOGIC OF COLLECTIVE ACTION (1965). See also *infra* part III.B.1 for a more detailed discussion of the collective action problem.

[4] *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992) [hereinafter Black, *Agents Watching Agents*]; Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) [hereinafter Black, *Shareholder Passivity*]; Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117 (1988); Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985 (1993) [hereinafter Gilson & Kraakman, *Guardian Shareholders*]; Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda For Institutional Investors*, 43 STAN. L. REV. 863 (1991) [hereinafter Gilson & Kraakman, *Reinventing*]; Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994) [hereinafter Gordon, *Institutions as Relational Investors*]; Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gate*, 45 STAN. L. REV. 857 (1993); Mark J. Roe, *A Political*

seen a great shift in the composition of shareholders. The Berle and Means corporation, with its thousands of dispersed shareholders, has given way to corporations with highly concentrated holdings in the hands of institutional investors.[5] As of 1991, over fifty percent of the equity of public corporations was held by institutional investors, such as public pension funds, mutual funds, bank trust departments, and private pension funds.[6] While this makes it easier for shareholders to cooperate and overcome the collective action problem, shareholder passivity persists.

Several commentators have proposed an "overregulation" explanation for shareholders' continuing inability to use the voting mechanism to influence management effectively.[7] These commentators argue that shareholder passivity is to a large extent historically contingent, rather than a necessary by-product of the corporate form.[8] In other words, even though structurally the collective action problem has become easier to overcome, regulatory roadblocks still stand in the way of effectively and systematically overcoming the problem. Shareholder activism, they claim, has been thwarted by political roadblocks, mostly in the form of regulations making it difficult for institutional shareholders to acquire large equity stakes in companies and thus exercise their "voice."[9] These commentators have concentrated their efforts on three principal strategies: (1) identifying the regulatory roadblocks and, in certain cases, making direct proposals for

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Theory of American Corporate Finance, 91 COLUM. L. REV. 10 (1991). Some commentators have been less optimistic about the potential for shareholder activism. *See, e.g.*, Jayne W. Barnard, *Institutional Investors and the New Corporate Governance*, 69 N. CAR. L. REV. 1135 (1991); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347 (1991) [hereinafter Gordon, *Shareholder Initiative*]; Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

[5] There are two principal reasons for increased shareholder activism: (1) the increased shareholdings by large institutional investors; and (2) the growing inefficiencies of the market for corporate control and the market for managers. *See* Gordon, *Shareholder Initiative*, *supra* note 4, at 347; Coffee, *supra* note 4, at 1279.

[6] *See* CAROL BRANCATO AND P. GAUGHAM, INSTITUTIONAL INVESTORS AND CAPITAL MARKETS: 1991 UPDATE 16 (Colum. L. Sch. Institutional Investor Project Sept. 12, 1991).

[7] *See* Black, *Agents Watching Agents*, *supra* note 4; Black, *Shareholder Passivity*, *supra* note 4; Roe, *supra* note 4. For a critique of the overregulation theory, see Coffee, *Liquidity Versus Control*, *supra* note 4.

[8] *See, e.g.*, Black, *Shareholder Passivity*, *supra* note 4, at 525.

[9] *See id.* at 523; Roe, *supra* note 4, at 16.

regulatory changes;[10] (2) creating a normative structure for justifying greater shareholder activism;[11] and (3) providing a positive account of the areas of successful and unsuccessful shareholder activism to date, as well as prescriptions regarding the types of activism that could be effective in the future.[12]

Thus, implicit in much current commentary is the claim that shareholders will be able to overcome the collective action problem if certain regulatory changes occur. The possibility of shareholder cooperation is never in question, but the nature of this group action has not been carefully examined. Such an undertaking is required if one is to understand the true potential of shareholder activism. This is of particular importance because acceptance of the overregulation school thesis and proposals would lead to a number of regulatory changes that could have ramifications outside the shareholder voting context.[13] As a result, some caution should be exercised until we have a greater understanding of the changing structure of shareholder activism and its effect on the shareholder voting mechanism.[14]

Implicit in the overregulation school arguments is the assumption that if proper regulatory changes are made, shareholders will be able to form

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[10] *See, e.g.*, Black, *Shareholder Passivity*, *supra* note 4, at 529-563; Conard, *supra* note 4; Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89 (1990); John Pound, *Proxy Voting and the SEC: Investor Protection Versus Market Efficiency*, 29 J. FIN. ECON. 241 (1991); Mark J. Roe, *Foundations of Corporate Finance: The 1906 Pacification of the Insurance Industry*, 93 COLUM. L. REV. 639 (1993) [hereinafter Roe, *Foundations*]; Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469 (1991); Roe, *supra* note 4, at 17-31.

[11] *See, e.g.*, Black, *Agents Watching Agents*, *supra* note 4.

[12] *See, e.g.*, Gilson & Kraakman, *Reinventing*, *supra* note 4 (emphasizing the new potential for effective monitoring by outside directors); Gordon, *Institutions as Relational Investors*, *supra* note 4 (proposing the use of cumulative voting to affect board structure).

[13] Some commentators have proposed specific regulatory changes which, they claim, will help institutional investors increase the size of their equity holdings in any one company. The claim is that the relaxation of certain regulations will lead to increased participation by institutional investors in the shareholder voting mechanism. *See, e.g.*, Black, *Agents Watching Agents*, *supra* note 4, at 830-31; Bernard S. Black, *Disclosure, Not Censorship: The Case for Proxy Reform*, 17 J. CORP. L. 49 (1991) [hereinafter Black, *Disclosure*]; Bernard S. Black, *Next Steps in Corporate Governance Reform: 13(d) Rules and Control Person Liability*, *in* MODERNIZING U.S. SECURITIES REGULATION: ECONOMIC AND LEGAL PERSPECTIVES 197 (Kenneth Lehn & Robert W. Kamphuis, Jr. eds., 1992); Bernard S. Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 1 (1992) [hereinafter Black, *Next Steps in Proxy Reform*].

[14] A number of commentators have called for caution. *See, e.g.*, Coffee, *supra* note 4; Rock, *supra* note 4; Gordon, *Shareholder Initiative*, *supra* note 4.

coalitions to effect cooperation.[15] This Article analyzes the nature of shareholder group action by focusing on the feasibility, with or without the regulations proposed, of forming shareholder coalitions.[16] The possibility of forming, as well as sustaining, coalitions is important if we want shareholder monitoring to be more than an ad hoc, one-period affair. Prior commentators have focused on a static analysis of the collective action problem in shareholder voting;[17] they have analyzed the problem as a one-time only action. In contrast, this Article argues that any promising involvement by shareholders will require more than acting in concert for one vote.[18] It presents a dynamic analysis, a multiperiod approach, of the possibility of such concerted action.

This Article identifies a major obstacle to the formation of shareholder coalitions: the fact that shareholders are not only potential cooperators, but also potential competitors. In other words, shareholders interact with each other in two different ways. When they exercise their voice option, they deal with each other as cooperators;[19] but when they are involved in the capital market, they act as competitors.[20] Thus, any attempt to deal

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[15] *See* Black, *Agents Watching Agents*, *supra* note 4, at 815-16 (advocating reform to "let six or ten institutions collectively have a significant say in corporate affairs, while limiting the power of any one institution to act on its own.").

[16] By coalition, I mean a group of individuals who make an agreement to implement a common strategy. For a general discussion of coalitions in the corporate governance area, see John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495 (1990).

[17] Frank Easterbrook, Daniel Fischel, and Edward Rock mention the potential of multiperiod coalitions, but do not provide a detailed analysis of the issues involved. *See* Easterbrook & Fischel, *supra* note 2, at 406. "Sometimes stable coalitions (a group of inside shareholders and some institutional allies) may hold effective control for long periods. This is beneficial . . . because it alleviates the collective action problem." *Id.*; *see also* Rock, *supra* note 4, at 465-66.

[18] The voting mechanism is not the only weapon available to shareholders for disciplining management. An alternative to discipline through the voting mechanism is discipline through the capital markets—generally this is referred to as the "exit" mechanism. Shareholders that are dissatisfied with the performance of the board and managers will sell their shares. Such action will eventually lead to a drop in the market price which reflects shareholder dissatisfaction with the company's performance. On the voice/exit distinction, see ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970).

[19] Overcoming the collective action problem usually requires some form of cooperation. *See* RUSSELL HARDIN, COLLECTIVE ACTION 62-64, 68 (1982); TERRY M. MOE, THE ORGANIZATION OF INTERESTS (1980); OLSON, *supra* note 3.

[20] The players in the capital markets are in constant competition with each other. This competition takes a number of forms. One type of competition is associated with the acquisition of information; another involves the evaluation of partial information; and the most important type of competition occurs in connection with the actual trading of stock. *See infra* Section IV.

with shareholder passivity will have to address the incompatibility of these roles. To date, commentators on the issue of shareholder voting have failed to factor in the second role of shareholders, that of competitors in the capital markets.[21] This has led to undue optimism about the ability of institutional investors to cooperate in disciplining management through the voting mechanism.[22] This Article argues that the issue of shareholder voting is more complex, in part because of the problematic interaction of shareholder cooperation and competition.

Part II of this Article discusses the recent changes in the characterization of shareholder passivity. Part III looks at the issue of shareholder cooperation. Part IV sets forth the argument regarding shareholder competition. Part V analyzes the potential for shareholder cooperation in light of the existence of shareholder competition. Part VI offers some conclusions.

II. From Relative Passivity to Relational Investing

Money encourages rational action,[23] even in those predisposed to act with little forethought. For this reason, corporate theorists have struggled to characterize shareholder passivity as a rational decision of shareholders.[24] Two principal explanations have been proposed: one based on the collective action problem and the other based on the existence of political roadblocks.

[21] That shareholders sometimes act as competitors has been addressed in the context of corporate takeovers. *See, e.g.*, Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985); Edward B. Rock, *Corporate Law Through an Antitrust Lens*, 92 COLUM. L. REV. 497, 501, 524-30 (1992); Edward B. Rock, *Antitrust and the Market for Corporate Control*, 77 CAL. L. REV. 1365 (1989).

[22] *See, e.g.*, Black, *Agents Watching Agents*, *supra* note 4, at 831 ("*potential* gains are substantial").

[23] We begin with the assumption that an individual has a subjective ranking of preferred actions. Then we can say that she acts "rationally" if she takes that action which she believes is most likely to achieve the end that she most desires, *i.e.*, that which she ranks the highest. *See* SHAUN HARGREAVES HEAP ET AL., THE THEORY OF CHOICE: A CRITICAL GUIDE 3 (1992); RATIONAL CHOICE 1, 1-4 (Jon Elster, ed., 1986).

[24] Adolf Berle and Gardiner Means initiated the debate on shareholder passivity. *See* BERLE & MEANS, *supra* note 1.

A. *Rational Passivity: A Collective Action Explanation*

Frank Easterbrook, Daniel Fischel,[25] Eugene Fama, and Michael Jensen[26] explain shareholder passivity as rational, given the collective action problems that constrain shareholder voting.[27] Easterbrook and Fischel argue that

> [b]ecause of the easy availability of the exit option through the stock market, the rational strategy for dissatisfied shareholders in most cases, given the collective action problem, is to disinvest rather than incur costs in attempting to bring about change through the voting process.[28]

If this is the case, a logical question is why we give shareholders the right to vote at all. Easterbrook and Fischel's answer is that voting must be worth something, otherwise managers would not expose themselves[29] to removal through the voting mechanism by giving shareholders the right to vote.[30]

Nevertheless, according to Easterbrook and Fischel, the value of voting should not be overestimated by regulators or courts.[31] They argue against the view that proxy rules should be strengthened to provide shareholders with more information and access to the proxy mechanism, thus encouraging shareholder activism. Such a view, they claim, assumes that shareholders want more information and greater involvement in corporate govern-

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[25] *See* Easterbrook & Fischel, *supra* note 2. Henry Manne was the first to focus on the economics of shareholder voting. *See* Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967); Henry G. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427 (1964).

[26] *See* Fama & Jensen, *supra* note 2, at 308-09.

[27] For an explanation of the collective action problem, see *supra* note 3 and accompanying text and *infra* part III.B.1.

[28] Easterbrook & Fischel, *supra* note 2, at 420.

[29] *See id.*; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 351-52 (1976).

[30] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67 (1991). The authors also argue that because shareholder voting has survived, it must matter. *Id.* at 70. On the survival of institutions, see Fama & Jensen, *supra* note 2, at 301. "Absent fiat, the form of organization that survives in an activity is the one that delivers the product demanded by customers at the lowest price while covering costs." *Id.*

[31] EASTERBROOK & FISCHEL, *supra* note 30, at 84 (explaining that although some voting may serve a valuable monitoring function, inferring, as the SEC does, that more voting is always better, is not necessarily the correct approach).

ance, two assumptions "that are not supported by the evidence."[32] They conclude that shareholders would prefer to limit the scope of their voting rights and the amount of information that managers must give them, because shareholders are rationally apathetic and conscious of the cost of producing and disclosing information that they will not want to use anyway.[33]

With the increased concentration of equity securities in the hands of a fairly small group of institutional investors, Easterbrook and Fischel's explanation has become less persuasive. The collective action problem, at least in theory,[34] should be less of a roadblock once the subgroup of shareholders capable of obtaining over fifty percent of the vote becomes smaller. Nevertheless, the increased accumulation of shares in the portfolios of institutional investors has not yielded a proportional increase in shareholder activism. Thus, a new explanation for shareholder apathy is needed.

B. Institutional Activism and the Shadow of the Law

Bernie Black,[35] Mark Roe,[36] and Alfred Conard,[37] among others,[38] have argued that the collective action problem is only part of the explanation.[39] A more important reason for shareholder passivity, they claim, is the web of state and federal regulations that make it harder for institutional investors to increase their equity stakes in companies and that increase the legal risks associated with greater activism.[40] The irony, they

[32] EASTERBROOK & FISCHEL, *supra* note 30, at 82-83. The authors go on to say that the disparity between the rhetoric of shareholder democracy and shareholder conduct shows that these assumptions do not hold. *Id.* at 83.

[33] *Id.*

[34] *See* OLSON, *supra* note 3.

[35] *See* Black, *Agents Watching Agents*, *supra* note 4; Black, *Shareholder Passivity*, *supra* note 4; Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992).

[36] *See* Roe, *supra* note 4; Roe, *Foundations*, *supra* note 10.

[37] *See* Conard, *supra* note 4.

[38] *See, e.g.*, Pound, *supra* note 10.

[39] A number of commentators have made comparative studies of institutional investors in the United States and other countries in order to better understand institutional investors in the United States. *See, e.g.*, Richard M. Buxbaum, *Institutional Owners and Corporate Managers, A Comparative Perspective*, 57 BROOK. L. REV. 1 (1991); Gilson & Kraakman, *supra* note 4; Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871 (1993).

[40] Alfred Conard was the first to argue this point. *See* Conard, *supra* note 4; *see also* Black,

argue, is that many of these regulations, such as the proxy rules, were either intended to help shareholders or else were aimed at other actors but have indirectly affected potentially activist investors.[41]

The legal rules in question and the type of actions circumscribed include:

(1) disclosure and the other requirements of the proxy rules;[42]
(2) proxy rule limitations on shareholder proposals;[43]
(3) disclosure requirements under Section 13(d) of the Securities Exchange Act of 1934 for any holder of five percent or more of a company's equity securities;[44]
(4) short-swing profit forfeiture rules under Section 16(b) of the Securities Exchange Act;[45]
(5) securities and bankruptcy laws and fiduciary definitions under state law that apply to "controlling persons";[46] and
(6) insider trading laws.[47]

According to these theorists, while legal rules are the greatest obstacle to shareholder activism, they are not the only one.[48] Other obstacles include the conflict of interest encountered by money managers who make both investment and voting decisions for institutional investors.[49] Institutional culture[50] is also to blame: Over the years, institutional investors

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Shareholder Passivity, *supra* note 4, at 523.

[41] *See* Black, *Agents Watching Agents*, *supra* note 4; Black, *Shareholder Passivity*, *supra* note 4; Roe, *supra* note 4.

[42] *See* Securities Exchange Act § 14, 15 U.S.C. § 78n (1988); 17 C.F.R. §§ 240.14a-3(a), .14a-11(e), .14a-12, .14a-9 (1994).

[43] *See* 17 C.F.R. § 240.14a-8 (1994).

[44] *See* Securities Exchange Act § 13(d), 15 U.S.C. § 78m(d) (1988); 17 C.F.R. §§ 240.13d-1 to 13d-7 (1994).

[45] *See* Securities Exchange Act § 16(b), 15 U.S.C. § 78p(b) (1988).

[46] *See, e.g.*, Securities Exchange Act § 15, 15 U.S.C. § 77o (1988); Blasius Indus. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

[47] *See* Securities Exchange Act § 10(b), 15 U.S.C. § 78j (1988); 17 C.F.R. § 240.10b-5 (1993).

[48] *See, e.g.*, Black, *Shareholder Passivity*, *supra* note 4, at 524-25.

[49] *See* Rock, *supra* note 4, at 469-72. Black is more optimistic than Rock on the possibility of overcoming these conflicts of interests. *See* Black, *Agents Watching Agents*, *supra* note 4, at 882-85. Some commentators have proposed regulatory changes to increase the participation of pension fund beneficiaries in the proxy process. The aim is to minimize the conflict of interest problem. *See, e.g.*, Myron P. Curzan & Mark L. Pelesh, *Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues*, 93 HARV. L. REV. 670 (1980).

[50] For an anthropological study of the role of institutional investor culture in affecting invest-

developed an attitude of passivity which has led to a degree of path dependence. Thus, changes in legal rules have not led to immediate changes in the level of activism.[51]

Overregulation theorists propose that legal rules be changed to encourage greater activism. Their goal is a system of "relational investing" in which shareholders view themselves as long-term investors rather than short-term traders.[52] In contrast, this Article argues that before we start changing rules, especially where these may have effects outside of the shareholder voting context, we should undertake a thorough analysis of what the changes will achieve and to what extent our goals are feasible. This Article assumes that the laws identified as problematic have all been changed. It then analyzes what effect this would have on shareholders' ability to form coalitions to discipline managers.[53] This methodology allows for the identification of a number of additional, nonlegal roadblocks to shareholder activism that must be taken into account by those who propose to change the current legal rules. In particular, this Article argues that the existence of competition among shareholders will have a significant effect on the ability of shareholders to cooperate in disciplining managers.

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ment and voting decisions, see William M. O'Barr & John M. Conley, *Managing Relationships: The Culture of Institutional Investing*, FIN. ANAL. J., Sept.-Oct. 1992, at 21.

[51] On path dependence, see DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 93-94 (1990).

[52] *See, e.g.*, Gordon, *Institutions as Relational Investors*, *supra* note 4, at 127.

[53] Bernie Black argues that the expected gains of greater shareholder voice are greater than the potential costs. *See* Black, *Agents Watching Agents*, *supra* note 4, at 831. He states:

> We can't today answer the counterfactual questions: How much monitoring would the institutions do if legal rules were different? How valuable is institutional oversight? I argue here that the potential gains are substantial. Combined with my argument . . . that the risks from institutional voice are small, the case for reform becomes: Let's try it.

Id. at 830-31. It is important, however, to explore these counterfactual questions more carefully because the costs may very well turn out to be greater than those Black anticipates, especially when one takes into account that many of these rules were adopted in response to issues other than shareholder voting, such as insider trading, takeovers, antitrust issues, and the riskiness of bank investment. The potential benefits may also turn out to be less than those Black expects. For these reasons, this Article assumes that all these rules have already been changed and it explores what sort of shareholder activism we would expect to see in a world without the legal barriers identified by Black. Dealing with counterfactuals is not as arduous a task as it first appears. *See generally* DAVID K. LEWIS, COUNTERFACTUALS (1973).

III. Cooperation Among Shareholders

At any one point, a shareholder has three options: (1) enter the capital market, either to buy more shares or to sell her shares, *i.e.*, to "exit" the corporation; (2) do nothing, that is, take a free ride on the actions of other shareholders; or (3) exercise her "voice" option. A shareholder can also choose to act individually or together with others. Using the exit option[54] is one way for a shareholder to act on her own. If, however, she chooses to stay in the corporation and attempts to bring about change, she can be said to be exercising her voice option.[55] If this voice is to be effective, it generally requires that shareholders act in concert.

This section looks at shareholder cooperation by examining the nature of shareholder voice. It focuses on the issue of shareholder voting and direct bargaining by shareholders with managers, and then analyzes the collective action problem in shareholder voice and examines the ways of getting around it.

A. *Shareholder Voice*

A shareholder exercises her voice option when she becomes involved in the corporate governance process. She incurs certain costs, hoping to receive a benefit that exceeds them. The goal of exercising the voice option is to maximize the return that the shareholder receives from her ownership of stock. In many circumstances, exercising the voice option will not produce as high a return to an individual shareholder as one of the other two options. However, if shareholders can form a coalition to share the costs of exercising the voice option, then each member of the coalition, as well as other shareholders who choose to take a free ride,[56] will be better off. For this reason, this Article focuses on the feasibility of shareholder coalition formation.

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[54] For a discussion of the "exit" option, see HIRSCHMAN, *supra* note 18. According to Hirschman: "[T]he exit option is widely held to be uniquely powerful: by inflicting revenue losses on delinquent management, exit is expected to induce that 'wonderful concentration of mind' akin to the one Samuel Johnson attributed to the prospect of being hanged." *Id.* at 21. This passage is referring to exit by dissatisfied consumers. *Id.*

[55] To resort to the voice option is to make an attempt at changing corporate policy without exiting the corporation. Hirschman defines "voice" as "any attempt at all to change, rather than to escape from, an objectionable state of affairs." HIRSCHMAN, *supra* note 18, at 30.

[56] This is "the 'exploitation' of the great by the small" that Mancur Olson identifies. *See* OLSON, *supra* note 3, at 35 (emphasis omitted).

Whether it makes sense for a shareholder to exercise her voice option will depend on the cost. This, in turn, depends on the type of actions that the shareholder takes to exercise her voice option. The proxy process is only one way for shareholders to exercise their voice—they may also seek to bargain directly with the board of directors or management. While these alternatives are somewhat interrelated, they are different in many ways and are, therefore, analyzed separately.

1. Voting Mechanism

Under state corporation laws, the holders of the common shares of a company are given the right to elect the board of directors[57] and to vote on certain other extraordinary transactions.[58] The board of directors is given the power to manage the company, which it does with the help of the managers. Direct management of the company is thus left to the board. Shareholder involvement is limited. It consists of their power to elect the directors. Recently, shareholders have increasingly proposed precatory resolutions, which, while not binding, inform the board of shareholders' views on certain matters.[59] Shareholders hope that the board will accede to their requests in order to dissuade shareholders from removing board members or from selling their shares.[60]

The shareholder voting mechanism is a way for shareholders to affect corporate policy indirectly through the election of directors and the adoption of precatory resolutions. The effectiveness of these devices in disciplining managers will depend on the ongoing nature of the threat of shareholder action. This threat cannot be a one-period affair; if shareholder coalitions are hard to put together and sustain, the usefulness of

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[57] *See, e.g.*, DEL. CODE ANN. tit. 8, § 211(b) (1993).

[58] Shareholders elect the members of the board of directors and thus indirectly affect corporate policy. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 141, 211, 214, 216 (1993). In addition, shareholders must approve a number of other transactions. These include, mergers, the sale of all or substantially all of the assets of the corporation, and the amendment of the certificate of incorporation. *E.g.*, DEL. CODE ANN. tit. 8 §§ 242(b) 251(b), 271(a), 275(b) (1993).

[59] *See, e.g.*, Gordon, *Shareholder Initiative*, *supra* note 4, at 351. Directors do not have to follow these resolutions.

[60] There is a well-developed literature on the reasons for restricting shareholders' role in management, which is beyond the scope of this Article. *See, e.g.*, *id.* at 351-57 (discussing what Gordon terms "the absolute delegation rule" from shareholders to managers).

the voting mechanism is greatly reduced. If, on the other hand, coalitions can be kept together on an ongoing basis, the deterrent effect of shareholder voting is vastly increased.

For example, assume that shareholders adopt a precatory resolution stating that the company should sell one of its divisions. The persuasive effect of the resolution will be a function of the probability that the coalition adopting it remains together long enough or can be reestablished easily at a special meeting or at the next annual meeting. The threat of shareholder exit may be another way of persuading directors to comply with the resolution, but this option will not be effective unless the threat is credible.[61]

2. *Bargaining by Shareholders*

In recent years, some institutional investors[62] have taken a very active role in directly negotiating with management and board members.[63] Dale Hanson, the head of CALPERS, has said that "[o]ur objective is dialogue, dialogue" and has proceeded to bargain with managers and directors on behalf of other shareholders.[64] Institutional investors have also begun to adopt active investment strategies aimed at directly influencing managerial decisions.[65] The relationship between shareholders and managers can be

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[61] On credible threats, see THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT (1960).

[62] One example of these active institutional investors is CALPERS, the California Public Employment Retirement System.

[63] *See* Susan Pullman, *CALPERS Goes Over CEO's Heads in Its Quest for Higher Returns*, WALL ST. J., Jan. 22, 1993, at C1 (discussing CALPERS strategy of negotiating directly with board members and management of companies such as General Motors, Westinghouse Electric, Advanced Micro Devices, Boise Cascade, Champion International, and Sizzler International).

[64] *See* George Anders, *Restless Natives: While Head of CALPERS Lectures other Firms, His Own Board Frets*, WALL ST. J., Jan. 29, 1993, at A1; *see also* Johnnie L. Roberts, *Time Warner Asks Big Shareholder For Board Advice*, WALL ST. J., Jan. 21, 1993, at B6; Joseph B. White, *CALPERS Activist Chief Wants To Take Larger Holdings in Fewer Companies*, WALL ST. J., May 7, 1993, at A12. "As a case in point, Mr. Hanson cited ITT Corp. 'Relationship investing is being able to say to Howard Aibel (ITT's Executive Vice President and Chief Legal Counsel): "Congratulations. Your stock hit $83,"' Mr. Hanson said. 'We began our conversations (with ITT management) about $45 ago.' "

[65] *See* LILLI A. GORDON & JOHN POUND, ACTIVE INVESTING IN THE U. S. EQUITY MARKETS: PAST PERFORMANCE AND FUTURE PROSPECTS (A Report Prepared for CALPERS, Jan. 11, 1993). According to the authors, active strategies

> typically involve exerting significant influence over corporate policy or control over the corporate entity in the hope of elevating the value of the firm. An active investment strategy

characterized as an ongoing bargaining interaction.[66] Managers enjoy great discretion in running the affairs of the corporation, which they use to increase their compensation packages[67] and their bargaining strength in future bargaining rounds with shareholders.[68] Thus, managers use their discretion to shape legal and nonlegal institutions affecting their relationship with shareholders.[69]

Shareholders bargain with managers through representatives.[70] Obvious examples include bargaining through the board of directors and through shareholders who bring derivative suits, lead proxy battles, or otherwise directly bargain with managers. In each of these circumstances, shareholders communicate certain preferences to managers and make certain

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> is thus one in which the returns derived from a given investment are endogenous—subject to influence by the individual investor after the investment is made. In economic terms, an active investor views [herself] as having market power, namely, the power to affect the outcome of an investment strategy by virtue of direct actions that . . . she undertakes.

Id. at 9.

[66] *See* Manuel A. Utset, *Towards A Bargaining Theory of the Firm*, 80 CORNELL L. REV. (forthcoming March 1995). A bargaining interaction is one in which two or more parties negotiate with each other regarding the possibility of cooperating in some venture. *See* John C. Harsanyi, *Bargaining, in* THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 190-95 (John Eatwell, et al., eds., 1987); John F. Nash, Jr., *The Bargaining Problem*, 18 ECONOMETRICA 155, 155 (1950).

[67] In a sense, shareholders and managers bargain over certain "substantive stakes" or "net organizational revenues." These are the revenues that are left after all fixed claimants are paid off. For example, the manager will seek additional compensation and the shareholder will attempt to increase dividends and retained earnings, *e.g.*, through reinvestment in positive net present value projects, which in turn is reflected in share price.

[68] One reason that managers do this is because they cannot diversify their human capital. In the course of her employment the manager will acquire two types of human capital: firm-specific and general human capital. General human capital is knowledge and expertise that is equally valuable in another firm, such as overall managerial skill and general business knowledge. Firm-specific human capital is knowledge that loses all or most of its value when the manager leaves the firm. *See* OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 254-256 (1985); John C. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 17-18 (1986) (comparing shareholders with managers and concluding that managers are overinvested in the firms that they manage because it is difficult for them to find equivalent employment, their compensation is tied to stock options and other nontransferable interests, and they do not have the protection of limited liability); Gary S. Becker, *Irrational Behavior & Economic Theory: Effects on Earnings*, 70 J. POL. ECON. 9 (1962).

[69] There are a number of formal and informal constraints that affect the shareholder-manager bargaining environment, including laws, informal institutional rules, and market mechanisms. The bargaining interactions that lead to the emergence and shaping of these constraints are a sort of "procedural stakes."

[70] In fact, institutional investors can be seen as acting as agents for the other shareholders. *See supra* part II.B.

threats. Managers react by ascertaining the expected actions of shareholders and devising a bargaining strategy. For example, managers may resist or give in to the board on a policy matter, or the managers may fight or settle a derivative lawsuit.

B. *Collective Action: The Shareholder as Potential Cooperator*

1. *Collective Action: The Problem*

The problem of collective action boils down to a conflict between individual and group interests.[71] In many cases, individuals will be better off by cooperating in order to achieve common goals that would be impossible to achieve individually. A collective action problem arises when the benefits produced by the organization are a collective good, one in which each member of the organization can partake, and from which no member can be denied enjoyment. Because the collective good will be shared by all, it will be in the interest of each not to incur any costs in providing the good, but instead to sit back and take a free ride on the organizational inputs of others. As a result, a collective good may go unrealized because no individual in the group is willing to provide the required input.

Collective action problems arise quite frequently in market economies. They can be analyzed as a form of market failure;[72] nevertheless, many organizations function quite well despite the potential for problems. This is because there are various ways of solving the collective action problem. Mancur Olson's *The Logic of Collective Action* is the classic treatment.[73]

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[71] There is an extensive literature on collective action problems and the possibility of getting around them. *See* KENNETH J. ARROW, THE LIMITS OF ORGANIZATION (1974); HARDIN, *supra* note 19; MOE, *supra* note 19; OLSON, *supra* note 3; DAVID REISMAN, THEORIES OF COLLECTIVE ACTION: DOWNS, OLSON AND HIRSCH (1990); TODD SANDLER, COLLECTIVE ACTION (1992); John Chamberlin, *Provision of Collective Goods as a Function of Group Size*, 68 AM. POL. SCI. REV. 707 (1974); Gerald Marwell & Ruth E. Ames, *Experiments on the Provision of Public Goods*, 84 AM. J. SOC. 1335 (1979); Pamela Oliver et al., *A Theory of the Critical Mass: Interdependence, Group Heterogeneity, and the Property of Collective Action*, 91 AM. J. SOC. 522 (1985); Carlisle Ford Runge, *Institutions and the Free Rider: The Assurance Problem in Collective Action*, 46 J. POL. 154 (1984); George J. Stigler, *Free Riders and Collective Action: An Appendix to Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 359 (1974).

[72] Kenneth Arrow argues that "organizations are a means of achieving the benefits of collective action in situations in which the price system fails." ARROW, supra note 71, at 33; *see also* Mancur Olson, *Collective Action*, *in* THE NEW PALGRAVE, *supra* note 66, at 474-77.

[73] OLSON, *supra* note 3; *see also* HARDIN, *supra* note 19; MOE, *supra* note 19; Sandler, *supra* note 71.

Olson divided groups into "privileged" and "latent." In a privileged group, at least one member has the incentive to contribute to the production of the collective good, even if she has to bear the full burden of providing it.[74] An individual would have such an incentive if the benefit from producing the good outweighed the cost of providing it. In a latent group, no single individual has an incentive to provide the collective good by herself.[75]

Olson identified a third type of group, which he classified as "intermediate." In this group, no single member has an incentive to provide the collective good by herself; however, the group is small enough to allow for a coalition to arise to provide the good.[76] Intermediate groups can really be seen as a type of latent group, in that no single individual in the group has an incentive to provide the collective good.[77] Because of this characteristic, this Article refers to intermediate groups as latent.

Latent groups can in turn be subdivided into those that are more likely and those that are less likely to overcome collective action problems. A latent group that is small, or one which, although large, has a small subgroup of members that have an incentive to provide the collective good, will find it easier to overcome collective action problems.[78] As seen in the next section, it is the latter form of potentially successful latent group that is of interest in the shareholder voting context.

There are various ways for latent groups to overcome the collective action problem. First, they might provide members with selective incentives[79]—private benefits provided only to those who contribute to the

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[74] OLSON, *supra* note 3, at 49-50. Olson presents the following formula to identify privileged and latent groups: $A_i = V_i - C$, where C = total cost of producing the collective good, V_i = gross benefit from the collective good to the individual i, and A_i = net benefit to i from i's contribution to the collective good. If $A_i > 0$ for some i, the group is privileged. If $A_i < 0$ for all i, the group is latent. *See id.* at 23; HARDIN, *supra* note 19, at 20.

[75] OLSON, *supra* note 3, at 49-50.

[76] *See* OLSON, *supra* note 3, at 50. If a group is small enough, members will be able to observe whether others are contributing to the provision of the collective good. This makes it easier for coalitions to be formed and enforced. *Id.*

[77] *See* HARDIN, *supra* note 19, at 40 (discussing Olson's analysis of latent groups).

[78] *See id.* at 41; THOMAS C. SCHELLING, MICROMOTIVES AND MACROBEHAVIOR 216-18 (1978); Rock, *supra* note 4.

[79] *See* OLSON, *supra* note 3, at 51 (describing incentives that are "selective" so that those who do not join the group cannot share in the incentives); MOE, *supra* note 19, at 28.

group.[80] Thus, while it may be difficult for groups to come into existence or stay together when their only incentive is a collective good, they may be able to do so if selective incentives are also available as private goods.

A second way in which a latent group can overcome the collective action problem is through cooperation among members.[81] This requires that members negotiate among themselves and reach an agreement on sharing the cost of providing a collective good. The smaller the group or subgroup, the easier it will be for cooperation to occur; with smaller groups, information, monitoring, and enforcement costs will be lower.[82] This will be explored further when the issue of potential coalitions among institutional investors is examined.[83]

2. *Collective Action and Shareholder Voting*

Shareholders are a group with a common interest: increasing the value of the corporation in which they hold shares. One way they can do this is by monitoring and disciplining management in order to reduce the agency costs[84] associated with the separation of ownership and control.[85] Any in-

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[80] *See* HARDIN, *supra* note 19, at 31; OLSON, *supra* note 3, at 133-34.

[81] *See* MOE, *supra* note 19, at 27 (explaining how subgroup members can assert themselves collectively through cooperation).

[82] On why smaller groups find it easier to overcome collective action problems, see OLSON, *supra* note 3, at 48-52.

[83] *See infra* part VI.

[84] On the agency theory of the firm see EASTERBROOK & FISCHEL, *supra* note 30; PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS (John W. Pratt & Richard J. Zeckhauser, eds., 1985); Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U.L. REV. 99 (1989); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Easterbrook & Fischel, *supra* note 2, at 395; Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Fama & Jensen, *supra* note 2; Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Michael C. Jensen, *Organization Theory and Methodology*, 58 ACCT. REV. 319 (1983); Jensen & Meckling, *supra* note 29; Michael C. Jensen & Jerold L. Zimmerman, *Management Compensation and the Managerial Labor Market*, 7 J. ACCT. & ECON. 3 (1985); William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521 (1982).

Agency theory has not been free from attack, especially among legal academics. Many of these critiques have come from commentators who believe that the agency paradigm does not actually describe the legal framework under which shareholders and managers interact. *See, e.g.*, RALPH NADER, MICHAEL GREEN AND JOEL SELIGMAN, TAMING THE GIANT CORPORATION (1976); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV.

crease in the value of the firm resulting from one shareholder's monitoring and disciplining actions is a collective good to be distributed among the other shareholders proportionally according to the amount of their holdings. Because every shareholder partakes in this increase in value, and no shareholder can be prevented from benefitting, a collective action problem arises.

This collective action problem may be overcome, however. When the portion of the collective good received by a shareholder is greater than the cost to her of undertaking monitoring and disciplining actions, the shareholder will act.[86] In such a case, the shareholders of that corporation are deemed a privileged group. In most cases, however, the cost to any individual shareholder will exceed her collective good benefit. When this is the case, the shareholders are considered a latent group. A latent group, as we have seen, can overcome the collective action problem under certain circumstances. One way to do this is through providing selective incentives. In this context, the selective incentives would be private benefits that a shareholder can derive from participating in monitoring and disciplining. Thus, the conclusion can be recast by saying that the collective action problem will be resolved whenever the sum of the collective good benefit and the private benefits exceeds the cost to any one shareholder of monitoring and disciplining management. In most instances, however, these aggregate benefits will not be enough to overcome the cost of involvement.

A second way to overcome the collective action problem discussed in the prior section is by having a group of shareholders organize themselves as a subgroup, or coalition, to provide the collective good. The formation of this coalition will make it more likely that the collective good will be provided where the aggregate benefit to the members of this coalition would exceed the cost of providing the good. The same collective action problem applies to the members of this subgroup coalition, but because the coalition is smaller than the entire group, its members will be better able to cooperate in sharing costs to overcome the problem.

L. REV. 597 (1982); Coffee, *supra* note 16, at 1495 n.1 (focusing on how agency theory overlooks "the degree to which other actors can influence or form alliances with the agent").

[85] The phrase "separation of ownership and control" comes from Adolf Berle's and Gardiner Means's influential 1932 book THE MODERN CORPORATION AND PRIVATE PROPERTY.

[86] If $A_i = V_i - C$ and $A_i > 0$, shareholder i will undertake action. In other words, the group will be privileged.

Increases in institutional investor shareholdings have made it easier to overcome the collective action problem in shareholder voting[87] because an institutional shareholder will, by virtue of its relatively large proportion of corporate holdings, receive a relatively large proportion of any collective good benefit produced. Nevertheless, it is very unlikely that a single institutional investor will have enough shares to make it worthwhile to undertake monitoring and disciplining management by itself. As a result, the collective action problem will more likely be overcome if a group of institutional shareholders can form a coalition to provide the collective good.

The larger the holdings each institutional investor has, the smaller this subgroup can be. This observation has led some commentators to argue that regulatory barriers currently making large share concentrations more difficult to acquire should be removed.[88] This argument fails to consider the fact that shareholders are not only potential cooperators in overcoming the collective action problem, but are also competitors in the capital markets. Shareholders' status as competitors will make it much more difficult to overcome the collective action problem, despite any deregulation that may occur.

A second key factor in whether the collective action problem can be overcome, even after one has factored in the competitive relations of shareholders, will be the role played by the market for information. This market has an important impact both on the capital market and on shareholder voice. The next section explores the role of coalitions in shareholder voting and the role of information in the shareholder voting context.

IV. Competition Among Shareholders

The corporate governance debate has tended to focus on the relationship between managers and shareholders, rather than on the relationship among shareholders.[89] Part of the reason for this is that management has

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[87] However, when the interests of these large shareholders conflict with those of smaller shareholders, the smaller shareholders will face an even greater collective action problem. Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1, 46 (1988) (discussing the problems of small shareholders in dual class recapitalizations).

[88] *See, e.g.*, Black, *Agents Watching Agents*, *supra* note 4; Black, *Shareholder Passivity*, *supra* note 4; Roe, *supra* note 4.

[89] *See infra* part V.

the most direct effect on shareholder wealth. Nevertheless, in order to monitor and discipline managers, shareholders must cooperate with each other, sharing information and allocating expenses. Their effort to cooperate in this way is frustrated by the fact that they are also in competition with one another in the capital markets. In that area, each investor's success is affected by her access to information and her ability to trade on it without divulging it to others. Thus, shareholders' role in the capital markets context is antithetical to their need, in the management discipline context, to share information and engage in other cooperative endeavors.

A. *Shareholder Competition*

Like other assets, shares are exchanged through market transactions.[90] An exchange takes place when two individuals value an asset differently—generally, the asset is transferred to the party that values it the most.[91] Problems of asymmetrical information, however, play an important role in the exchange of shares,[92] which represent claims on future corporate income. Where one party has more information than the other about the asset in question, the resulting exchange may not actually result in the asset being transferred to the party that values it the most.[93]

It is up to the shareholders' agents, the board of directors and management, to make decisions about corporate operations,[94] such as which projects to undertake. If managers choose projects with positive net present values, shareholders will be better off. Because managerial action is not easily observable, and because management controls access to information about corporate performance, shareholders have imperfect information regarding future income streams. This does not mean that sharehold-

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[90] One can draw a distinction between financial assets, such as shares, and real capital assets. Financial assets such as shares represent a claim on income streams generated from actual physical goods, or real assets. *See* Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 767 (1985).

[91] This is assuming perfect information and competition, *i.e.*, no market imperfections.

[92] On the interrelationship between the market for information and the capital markets, see Nicholas J. Gonedes, *The Capital Market, The Market for Information, and External Accounting*, 31 J. FIN. 611, 615 (1976) (need to specifically focus on the market for information if we are to understand the concept of market efficiency).

[93] *See* Andrew Postlewaite, *Asymmetric Information*, *in* THE NEW PALGRAVE, *supra* note 66, at 135.

[94] *See* DEL. STAT. ANN. tit. 8, §141(a) (1993).

ers have no access to information. Federal securities laws require the disclosure of certain information by public companies[95] and, in addition, a number of market constraints lead managers to disclose information.[96] What it does mean, however, is that a shareholder or potential investor with access to information not available to another party in an exchange transaction will be better off, as better informed parties can take advantage of the informational asymmetry to value the shares more accurately.[97] A well-informed investor will not sell unless she receives at least fair market value for her shares.

Finance theory tells us that buyers and sellers of shares will rarely be able to take advantage of asymmetric information because the markets for selling shares of a large public corporation, which generally take place through organized stock exchanges, are considered to be efficient.[98] If the capital markets were perfectly efficient, investors would have no incentive to acquire information for use in trading to their advantage; thus, there

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[95] For example, the Securities Exchange Act of 1934 requires periodic disclosure of material information to the capital markets following any material change. Securities Exchange Act of 1934, 15 U.S.C. § 78m (1994). The Securities and Exchange Commission requires, among other things, an annual report on Form 10K, quarterly reports on Form 10Q, and periodic reports on Form 8K. 17 C.F.R. §§ 249.308, .308(a), .310 (1994).

[96] *See* EASTERBROOK & FISCHEL, *supra* note 30, at 280-83. For a more general discussion of these market constraints, see Fama & Jensen, *supra* note 2.

[97] A number of economists and other commentators have focused on the issue of asymmetric information among transacting parties. In particular, they have analyzed how giving property rights in information provides incentives for producing information (finding or buying useful information) and how disclosure requirements sometimes provide a disincentive for acquiring useful information. *See, e.g.*, John P. Gould, *Privacy and the Economics of Information*, 9 J. LEG. STUD. 827 (1980); Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Incentive Activity*, 61 AM. ECON. REV. 561 (1971); Edmund W. Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEG. STUD. 683 (1980); Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEG. STUD. 1 (1978); William Samuelson, *Bargaining Under Asymmetric Information*, 52 ECONOMETRICA 995 (1984); Steven Shavell, Acquisition and Disclosure of Information Prior to Economic Exchange (1991) (unpublished Discussion Paper No. 91, Harvard Law School Program in Law and Economics).

[98] An empirical study by Peter Davies and Michael Canes found that secondary dissemination of information by stock analysts to their clients significantly affected share prices. The inference that can be drawn from the evidence they amassed is that the dissemination of primary information did not bring about the complete adjustment to the stock price which is predicted by the Efficient Capital Markets Hypothesis (ECMH). *See* Peter Lloyd Davies & Michael Canes, *Stock Prices and the Publication of Second-Hand Information*, 51 J. BUS. 43 (1978). The efficiency of capital markets is not as great as originally assumed. For a discussion of some of the problems with the received Efficient Capital Markets Hypothesis, see Lawrence H. Summers, *Does the Stock Market Rationally Reflect Fundamental Values*, *in* ADVANCES IN BEHAVIORAL FINANCE (Richard H. Thaler ed., 1993).

would be little competition among shareholders for the acquisition of information.

As will be seen in the next section, however, there is in fact competition among shareholders to acquire and use information to their advantage because the market is not perfectly efficient. In addition, the efficiency of the capital markets will be seen to depend on the competition among investors in acquiring information about the corporations in which they trade.

B. *The Incentive to Acquire Information*

The question that needs to be addressed is whether it ever makes sense for a market participant to acquire information about the corporations in which she is buying or selling shares. If information were free, all market participants would have the same information, which would be exactly that information required to make an investment decision. We would expect to find a Pareto optimal allocation of shares. Information, however, is costly. As a result, market participants must purchase information regarding the relevant corporations. If we assume that a market participant wants to maximize her wealth, she will only acquire information to the point that the benefit derived from that information is greater than the cost of acquiring it.

The potential benefit of acquiring information is that it allows a market participant to identify corporations with shares that are over- or undervalued. The participant will then have an advantage when trading with others who are not privy to this information. However, as noted above,[99] finance theorists have traditionally argued that the capital markets in the United States are efficient, and that all public information is reflected immediately in stock prices.[100] As a result, no market participant could use the available information to identify over- or undervalued shares.[101] By the time a trader acquired such information, the market would already

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[99] *See supra* note 98 and accompanying text.

[100] The strong form of the Efficient Capital Markets Hypothesis tells us that market prices reflect even inside information. There is, however, little empirical evidence supporting such a claim. The semistrong version of the ECMH tell us that market prices reflect all information that has been made available to the markets. There is a large body of empirical evidence supporting this claim. *See* CORPORATE FINANCE 338-45 (Stephen A. Ross & Randolph Westerfield eds., 2d ed. 1990).

[101] In other words, investors should only expect to receive an equilibrium rate of return. *Id.* at 339.

have processed it, and the price of those shares would already have taken it into account. Thus, in an efficient market, shares would not be undervalued or overvalued for any significantly long period of time.

The relationship of information to an efficient market is not as simple as this description makes it seem, however. Information is not magically reflected in the market price of shares. Efficient markets are efficient because there is a large number of analysts and traders in constant competition with each other over the acquisition of information.[102] Whenever new information is revealed, these competitors will trade on it until any possibility of making an arbitrage profit is exhausted. The greater the number of market participants following a company, the more quickly new information will be reflected in that company's share price. By the same token, the larger the number of participants, the less likely it is that any one of them will be able to systematically profit on trading when information becomes available.

There is a well known paradox inherent in the Efficient Capital Markets Hypothesis.[103] If market participants could not systematically profit from their investments in gathering information, then they would have no incentive to acquire information and trade on it.[104] However, if all market participants decided not to acquire information, then the markets would not be efficient and there *would* be room for participants to acquire information and use it to make arbitrage profits.[105] This paradox occurs because market efficiency arises from the competition among analysts and traders to acquire information and trade on it. In other words, capital markets will immediately reflect all available information only when analysts and traders ferret out information and trade on it before others acquire the same information. As a result, in any efficient market there must be market participants who will undertake to acquire information and

[102] It is ironic that information appears to be both the scarcest and most abundant commodity in Wall Street.

[103] *See* Gordon & Kornhauser, *supra* note 90, at 792-95.

[104] Market participants will only acquire information in situations where such strategies will produce a positive return.

[105] For a critique of using regulatory incentives to increase market efficiency, see Lynn A Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613 (1988).

trade on it instead of merely relying on the current market price as a true indicator of the value of shares.[106]

Not all market participants will have the same incentives to purchase information, however. Large investors, such as institutional investors, will be more likely to purchase information because, on a portfolio dollar basis, they bear lower costs in purchasing this information. In addition, for certain types of information there may be large threshold amounts that must be purchased to make the information useful.[107]

The above discussion yields several conclusions. First, even if capital markets are efficient, there will be a large number of market participants competing with each other to acquire and use information to make arbitrage profits. Second, while some of these market participants will be engaged in the acquisition of information because the benefits of doing so exceed the costs, others will do so out of the misguided belief that they can still beat the market, *i.e.*, that the market is inefficient. Both types of market participants will compete actively in the market for information,[108] and thus they will be less willing to share information to overcome the collective action problem in shareholder voting. Finally, as finance theorists have recently begun to acknowledge, we cannot assume that all shareholders will have homogeneous interests.[109]

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[106] This does not mean that these market participants will always purchase the optimal amount of information. *See* Gordon & Kornhauser, *supra* note 90, at 794. Sanford Grossman and Joseph Stiglitz have shown that market prices do not reveal all available information and thus it is profitable to acquire some information. *See* Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980); *see also* Davies & Canes, *supra* note 98 (discussing an empirical study that showed that the dissemination of primary information did not bring about the complete adjustment to the stock price which was predicted by the Efficient Capital Markets Hypothesis).

[107] *See* Gordon & Kornhauser, *supra* note 90, at 794; Rock, *supra* note 4.

[108] One can argue that the latter group will eventually realize that they cannot make profits. However, the ECMH theory has existed for some time, and a significant amount of fundamental and technical analysis continues.

[109] For a discussion of heterogeneous expectations, see, for example, Robert Jarrow, *Heterogeneous Expectations, Restrictions on Short Sales, and Equilibrium Asset Prices*, 35 J. FIN. 1105 (1980); Louis Makowski & Lynne Pepall, *Easy Proofs of Unanimity and Optimality without Spanning: A Pedagogical Note*, 40 J. FIN. 1245 (1985); Joram Mayshar, *On Divergence of Opinion and Imperfections in Capital Markets*, 73 AM. ECON. REV. 114 (1983); Edward M. Miller, *Risk, Uncertainty, and Divergence of Opinion*, 32 J. FIN. 1151 (1977); Robert E. Verrecchia, *Information Acquisition in a Noisy Rational Expectations Economy*, 50 ECONOMETRICA 1415 (1982).

C. Shareholder Competition Scorned

The issue of shareholder competition has received very little theoretical focus for three main reasons. First, there is the issue of theoretical baggage: Theorists have traditionally explained shareholder passivity as a product of the collective action problem. Because collective action is essentially a problem of cooperation, it is natural that the theoretical focus be concentrated there.[110] It is not surprising that commentators have taken this tack. Shareholders of large public corporations comprise a large group. As seen above, collective action theorists from Mancur Olson onward have focused on group size as an important determinant of the collective action problem—the smaller the group, the easier it is to overcome a collective action problem.[111] As institutional investors began to take larger stakes in public corporations, the size of the group of shareholders, or more importantly, the size of the coalition required to overcome the collective action problem, became smaller. Thus, the transformation in share-ownership structure led theorists to focus on the possibility of overcoming the collective action problem. They honed in immediately on the emerging prospect of cooperation. Time and theoretical parsimony aside, focusing on shareholder cooperation does not preclude incorporating the issue of competition into an explanation of shareholder cooperation.

A second roadblock to focusing on shareholder competition has been the Efficient Capital Market Hypothesis (ECMH). Accepting the ECMH leads to a conclusion that shareholders cannot make systematic profits from information that they acquire at a cost. If this is the case, shareholders will not compete with one another in the market for information because it would be irrational for them to do so. The limitations of this argument were explained above, as was the counter-argument that shareholders do, in fact, compete in the market for information.[112] For purposes of this argument, the issue of whether this competition is rational does not need to be resolved.

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[110] *See* Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CAL. L. REV. 1671, 1695 (1985). Some theorists, such as Frank Easterbrook and Daniel Fischel, assume that the "market for voice" is separate from the "market for exit." "It is a necessary condition of the economic rationale that these two markets be separable because each provides an independent monitoring system." *Id.*

[111] *See supra* part III.B.

[112] *See supra* part IV.B.

A final reason theorists have overlooked the issue of shareholder competition is that shareholders are traditionally assumed to be price-takers. It is assumed that their purchase or sale of shares cannot affect market prices. This assumption makes sense in a market of small, autonomous shareholders. In the current market, however, with large institutional investors taking large stakes in companies, the assumption of price-taking shareholders must be relaxed. These institutional investors can, in fact, affect the market price through their buying and selling activities.

V. Relationship Between Shareholder Cooperation and Competition

The principle argument of this Article is that one cannot understand shareholder cooperation without factoring in the role played by shareholder competition. The first part of this section provides a simple example elucidating how shareholder cooperation and competition are intertwined. It then looks at the role played by the market for information. Finally, the potential for forming shareholder coalitions and the problems of keeping them together are analyzed.

A. *Shareholder Cooperation and Competition: An Example*

Assume that company ZYX, Inc., a public corporation listed on the New York Stock Exchange, has five shareholders who together own fifty-one percent of the company and many other smaller shareholders. Each shareholder is trying to maximize the return from her investment in ZYX. For our purposes, assume these returns arise in two contexts: (1) the capital markets, where acquisition of information is used to make arbitrage profits; and (2) the shareholder voice mechanism, where shareholders increase the value of the company by disciplining managers.

In both contexts, the actions of one shareholder will affect the others. In the capital markets context, for example, Shareholder 1 affects the payoffs to Shareholder 2 either by trading with her when Shareholder 1 has better information, or by affecting the market price of the shares by buying or selling large blocks of shares.[113] None of this is surprising; in fact, such competition is assumed to be inherent in market transactions. What is

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[113] The assumption that the shareholders are price-takers is relaxed here.

important is that such competition affects shareholders not only in the capital market context, but also in the second context in which they interact, the voice scenario.

Shareholders involved in corporate governance, either through bargaining with managers or by voting their shares, are interacting in the voice context. As seen in the discussion of the collective action problem, the payoffs to each shareholder will depend on what actions other shareholders take.[114] A shareholder who can take a free ride on the actions of others will get a higher payoff than if she had become actively involved in the governance process—this fact leads to the collective action problem. Payoffs will thus depend on shareholders' ability to form coalitions and keep them together. Failure to get at least fifty-one percent of the vote, for example, will yield a negative return from the governance process.

Critically, the ability to form these coalitions will be hampered by the fact that their formation requires shareholders to share information. As the discussion above indicates, however, shareholders will be reluctant to share information unless they have already been able to gain any profit that they can from using that information in the capital market. More important, however, is the problem of the verifiability of the information shared. Because shareholders are competing in the capital markets, they have an incentive to act opportunistically, to give the wrong information when sharing information. Thus, shareholders receiving information will hesitate to believe it unless they can independently verify the information, or unless the revealing shareholder can somehow offer a hostage or bond. Therefore, the fact that shareholders compete in the capital market context will affect their payoffs in the voice context.

The converse is also true. The fact that shareholders are involved in the voice scenario will affect the payoffs in the capital market. For example, shareholders involved in corporate governance may have greater access to information from managers. This could be hard information used by managers to bribe the shareholders, soft information, or secondary information that will help a shareholder verify the information she currently has.

The purpose of this example is to show how the relationship among shareholders can be modeled as a game[115] comprising two subgames. In

[114] *See supra* part III.B.

[115] A "game" for this purpose is defined as "a situation in which the actions of one person

trying to decide how to act, a shareholder will take into account her involvement in both subgames: one in the capital markets and the other in the governance context. The payoffs in each are affected by the payoffs in the other. Clearly, in order to understand shareholder decisionmaking, one cannot focus solely on the potential for gain through cooperation. The competition game must also be brought into the picture.

B. *Shareholder Voice and the Market for Information*

In both of the scenarios in which shareholders interact—the capital markets, where they are competitors, and the shareholder voting context, where they are potentially cooperators—the role of information is paramount. This section explores the role of information in the voting context. The following section analyzes the role that the distribution of information plays in the formation and stability of shareholder coalitions.

1. *Information, Uncertainty, and Shareholder Voting*

Uncertainty arises from the fact that we never have a full description of the world that we know to be true.[116] By acquiring information, we get a better sense of what a true description might be; our uncertain future becomes a bit more certain. As a result, information is a valuable commodity. If information were free and our ability to process it boundless, we would be able to reduce many of the uncertainties that we face in the corporate context.[117] However, neither of these two characteristics are true of information in the real world. In fact, information is a scarce and thus costly commodity,[118] and individuals have limits on their ability to process information.[119]

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perceptibly affect the welfare of another or vice versa. . . . [T]he basic method of game theory is to argue that individuals try to predict what others will do in reply to their own actions, and then optimize on the understanding that others are thinking in the same way." SHAUN HARGREAVES HEAP ET AL., THE THEORY OF CHOICE 94 (1992).

For some recent examples of the application of game theory to corporate law issues, see Ian Ayres, *The Possibility of Inefficient Corporate Contracts*, 60 CIN. L. REV. 387 (1991); John C. Coffee, *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495 (1990); David Leebron, *Games Corporations Play: A Theory of Tender Offers*, 61 N.Y.U. L. REV. 153 (1986); Utset, *supra* note 66.

[116] *See* ARROW, *supra* note 71, at 33-34.

[117] *See* WILLIAMSON, *supra* note 68.

[118] On the role of information costs and the incentives of parties to acquire information, see ARROW, *supra* note 71; FREDERICH A. HAYEK, INDIVIDUALISM AND ECONOMIC ORDER 77-91

The value of a company to a shareholder changes periodically because the company is subject to uncertainty about its future prospects, *i.e.*, its future earnings stream. For example, the company may be subject to future changes in market conditions that are hard to anticipate. A shareholder who wishes to maximize her investment in a particular company will continually reevaluate her investment by considering all relevant variables affecting the value of the company given any new information received.[120] The new information will allow her to change her probability distribution over future outcomes. Thus, she will be able to make a decision regarding her investment in light of her new understanding of the state of the world. For purposes of simplicity, the possible decisions that she can make are limited to the following: she can do nothing, enter the capital market to buy or sell shares, participate in the voice mechanism (*e.g.*, become involved in the shareholder voting mechanism), or acquire more information in order to make a better decision. These decisions can be distinguished as those that lead to "terminal acts," which are the first three choices, and those that require the acquisition of more information.[121]

2. *Terminal Acts*

An example will help clarify matters. On day one, Shareholder X values her investment in ABC, Inc., at $100, based on the information she then has. This information pertains both to past events and to probability distributions concerning a range of possible future events. One possible future event is the award of a lucrative contract to ABC, Inc., by XYZ, Inc. On day two, Shareholder X receives a new bit of information: The

(1948); JACK HIRSHLEIFER & JOHN G. RILEY, THE ANALYTICS OF UNCERTAINTY AND INFORMATION (1992); Kenneth J. Arrow, *Informational Structure of the Firm*, PAPERS & PROC. AM. ECON. ASSOC. 303 (1985); Yoram Barzel, *Measurement Cost and the Organization of Markets*, 25 J. L. & ECON. 27 (1982); Yoram Barzel, *Some Fallacies in the Interpretation of Information Costs*, 20 J. L. & ECON. 291 (1977); Steven Shavell, *Liability and the Incentive to Obtain Information About Risk*, 21 J. LEG. STUD. 259 (1992).

[119] *See* WILLIAMSON, *supra* note 68.

[120] *See* ARROW, *supra* note 71, at 47. The value of the company to the shareholder is also affected by the fact that she cannot fully monitor management. Thus, management may impose certain additional costs on shareholders.

[121] *See* ARROW, *supra* note 71, at 49; HIRSHLEIFER & RILEY, *supra* note 118.

CEOs of ABC, Inc., and XYZ, Inc., had met for ten hours and left the conference room shaking hands. Shareholder X formulates a new probability distribution to reflect her belief that a contract is now more likely. Thus, at the end of day two, Shareholder X will have a new valuation of her investment on the basis of the new information. She will then be able to decide what she wants to do. As noted above, one possibility is to do nothing. Another possibility is to enter the capital markets to buy additional shares.[122] Shareholder X may also want to exercise the voice option. She may, for example, contact management and threaten a proxy fight if management does not do everything in its power to secure the contract.[123] These options lead to terminal acts. Shareholder X may also want to acquire more information about the contract. This would allow her to become more certain about the possibility of the contract being awarded to ABC, Inc., and thus make a more accurate decision.

As illustrated, information plays an important role in shareholder investment decisions. Thus, it is important to focus more closely on the market for this information, specifically, when and how a shareholder will seek to acquire it.

3. *The Acquisition of Information*

As mentioned above, information is a scarce and thus costly resource. A shareholder will acquire an additional bit of information only when the cost of acquisition is less than or equal to the benefit that information confers. Because information can be reused once it is acquired, information may produce a benefit over time.[124] As a result, information is a type of capital asset, and a shareholder deciding whether to acquire such infor-

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[122] The ECMH tells us that this new information will be reflected rapidly in the price of the shares of ABC, Inc. Shareholder X will be able to profit from trading on this information to the extent that the market has not yet reached a new equilibrium reflecting this new information.

[123] This example demonstrates that the options of entering the market and exercising voice are not always mutually exclusive. The usual dichotomy is between exercising voice to try to improve that company's value, and exiting, where the shareholder sells its shares in the market. Shareholders frequently choose the exit strategy because of the cost of the voice option and the free-rider problem associated with shareholder voting.

[124] In certain cases, information may be useful only for a very short period of time, *i.e.*, it becomes obsolete. For example, the information acquired may relate to an issue that will only be decided once. A shareholder facing a decision whether to vote for a merger will have different incentives in acquiring information than if she were trying to make a decision relating to an ongoing corporate issue.

mation will compare the return over time provided by this investment in information to the return that could be expected from different investments. An investment in information is irreversible and thus is a type of "sunk cost."[125]

Shareholders acquiring shares bear three main types of costs: the cost of acquisition, the cost of processing the information, and the cost of verification.[126] In analyzing the issue of shareholder voting from an informational perspective, it is useful to divide our analysis into the three different decisions that shareholders must make. Each of these decisions requires the acquisition of different types of information. In some cases, reaching the socially optimal result requires that shareholders share or exchange information.[127]

The first decision that a shareholder faced with a vote must make is whether to vote at all. This is a fairly easy decision, because the act of voting does not take that much time or expense. The second decision is whether to vote with management, *i.e.*, grant a proxy to management, or to oppose management. This is a harder decision because it usually requires that a shareholder become informed about the issues, which takes time and expense.[128] This second decision is essentially whether the shareholder will become informed about the voting issues.

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[125] *See* ARROW, *supra* note 71, at 40.

[126] *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 594 (1984). The cost of acquisition includes the cost of producing the information or acquiring it from someone who has produced it. The cost of processing includes the human capital expended in interpreting the information and relating it to prior information known by the individual acquiring it. The cost of verification includes the cost to an originator of information of ascertaining the accuracy of information produced and the cost to a subsequent acquirer of information of ascertaining the accuracy of the information and the veracity of the originator. *Id.* The issue of verification raises issues of opportunism by the provider of the information. *Id.* at 595.

[127] If shareholders can organize themselves into a coalition, it will be easier to share this information. However, as this Article argues, there are numerous reasons why shareholders may either be reluctant to share information or have an incentive to act opportunistically when sharing such information.

[128] Some shareholders may adopt a default rule that they will always vote for management. This will not require the acquisition of any new information. Some institutional investors have urged shareholders to effectuate a "just vote no" stance, that is, to adopt a default rule that shareholders will vote against management in certain types of corporate governance issues. *See generally* Grundfest, *supra* note 4. Shareholders who adopt this position must still acquire some information, such as on which type of proposals to "just vote no." In addition, proponents of this policy will have to incur certain costs in convincing the other shareholders. *Id.*

If a shareholder decides to oppose management, she can do so in different ways. One way is simply by voting against management's proposals.[129] The only information the shareholder would then require would be information about the particular proposals being considered. For example, Shareholder X receives a proxy statement and solicitation of proxy from management on a management proposal to adopt certain takeover defenses. If the shareholder decides to vote, then she must decide whether to vote with or against management.[130] The question the shareholder will ask herself is whether to make this terminal decision with the information that she currently possesses or to acquire more information in order to make a more informed decision.

Another way for shareholders to oppose management is by taking a more active stance, such as trying to organize other shareholders to vote against management. The most effective way to achieve this result is for the shareholder to make her own proposals, such as offering either her own slate of directors or her own resolutions for a vote.[131] It is this active way of opposing management that poses the most interesting questions because it allows shareholders to have a positive voice instead of merely a negative one, *i.e.*, merely voting against management without making a counter-proposal. It also requires that one or more shareholders take an active role in organizing the others.[132]

The third decision that a shareholder must make is applicable only if she has decided to oppose management: How much should she spend in opposing management and should she seek out other shareholders to share these expenses? How much a shareholder spends depends on how she chooses to oppose management and how strenuously she plans to do so. This involves making decisions about whether to make her own proposal, whether to organize a shareholder coalition to share costs, and how much information is needed to reach a decision.

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[129] These proposals could include such things as management's slate of directors or resolutions proposed by management.

[130] The same analysis would apply in a situation where the shareholder receives a proxy statement from another shareholder opposing management on some issue.

[131] The shareholder wishing to present a resolution in a shareholder meeting must comply with the proxy rules.

[132] This organizing may include such activities as trying to convince the other shareholders to vote in the same manner as the proponents or actually organizing the shareholders into a group that will share the costs of opposing management.

VI. THE LIMITS OF SHAREHOLDER COOPERATION: COALITION FORMATION AND DISSOLUTION

As argued above, disciplining managers[133] requires some form of shareholder cooperation. Ultimately, cooperation is the only way to overcome the collective action problem.[134] In the shareholder voting context, the collective action problem manifests itself in two ways. One is when shareholders are trying to decide whether to propose resolutions, carry out a proxy fight, or both. The second collective action problem arises when shareholders are deciding whether and for whom to vote.

If we are to see any significant increase in shareholder activism, these two collective action problems must be overcome. As discussed above, there are a number of ways to do this. One way occurs in cases where the benefits to a single individual in the group exceed the cost to that individual of providing the collective good. A second way is through the formation of a coalition[135] or subgroup to which the aggregate benefit exceeds the cost of providing the collective good. In other words, the coalition is a vehicle by which a certain subgroup of the whole agrees to cooperate in sharing costs.

The main obstacle to shareholder activism is the collective action problem among potential proponents of resolutions—those who actively oppose management and try to get others to join in the proxy effort. One way of

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[133] Examples of discipline include limiting the amount of compensation paid to managers, ensuring that good managers are hired and that bad ones are let go, and that the whole team of managers works as hard and as efficiently as they possibly can. The goal is for managers to behave in the same way that the shareholders would behave if they were actually managing the company.

[134] For a discussion of how interacting parties can learn to cooperate, see MICHAEL TAYLOR, THE POSSIBILITY OF COOPERATION (1987); Robert Axelrod, *An Evolutionary Approach to Norms*, 80 AM. POL. SCI. REV. 1095 (1986); Robert Axelrod & Douglas Dion, *The Further Evolution of Cooperation*, 242 SCIENCE 1385 (1988); Jonathan Bendor & Dilip Mookherjee, *Norms, Third-Party Sanctions, and Cooperation*, 6 J. L., ECON., & ORG. 33 (1990); David Kreps et al., *Rational Cooperation in the Finitely Repeated Prisoners' Dilemma*, 27 J. ECON. THEORY 245 (1982); Stergios Skaperdas, *Cooperation, Conflict, and Power in the Absence of Property Rights*, 82 AM. ECON. REV. 720 (1992); Lester G. Telser, *Cooperation, Competition, and Efficiency*, 28 J. L. & ECON. 271 (1985).

[135] A coalition is a group of individuals who are able to make some sort of agreement to implement a common strategy. In the formal game theory literature on cooperative games, there is usually an assumption that one can make a *binding* agreement. *See* HEAP ET AL., *supra* note 115, at 95 ("[A] *coalition* is a group of players who are able to make binding agreements to implement agreed strategies.").

circumventing this problem is by encouraging certain shareholders to acquire large stakes in a company so that, in many cases, their share of the collective good would exceed the cost of providing the good.[136] However, there are numerous reasons why this is unlikely to be a good strategy. First, taking such a large stake in a company makes it harder to exit the company, which many shareholders would find undesirable.[137] Second, having large stakeholders creates additional problems for other shareholders, such as abuse by the large stakeholders. Third, the main candidates to become such stakeholders are large institutional investors and financial institutions. There are a number of policy reasons why we would want to restrict the concentration of corporate equity in the hands of such investors.[138]

Because the single-proponent solution is not viable, the alternative is a coalition or subgroup providing the collective good.[139] Implicit in the arguments of commentators who advocate "relational investing" is the belief that such a coalition can be formed.[140] Thus, we need to analyze the like-

[136] That is, the cost of producing the collective good remains the same, or decreases, while the proportional share of the benefit will increase.

[137] *See* Coffee, *supra* note 4.

[138] For some of the historical background to restrictions on financial institutions, see Roe, *supra* note 4.

[139] Two types of coalitions among shareholders concern us: a coalition of voting shareholders and a coalition of proponents. In order for a resolution to be adopted or a director to be elected, a majority of shareholders must vote in favor. (In some cases the Certificate of Incorporation may provide that certain resolutions require more than a 51% vote. These supermajority voting provisions are frequent in antitakeover provisions.) Thus, implicit or explicit cooperation among holders of at least 51% of the shares is required. This group of cooperating shareholders is called a "voting coalition." Voting coalitions do not arise spontaneously. One or more shareholders must take on an additional role of identifying the relevant policy issues and determining how to produce the corporate change desired. Shareholders who undertake such tasks are called "shareholder proponents" or simply "proponents." They will need to convince holders of at least 51% of the shares to form a voting coalition.

[140] *See, e.g.*, Black, *Agents Watching Agents*, *supra* note 4, at 815-816. Black states:

> I believe that there is a strong case for measured reform that will facilitate joint shareholder action *not directed at control,* and reduce obstacles to particular institutions owning stakes *not large enough to confer working control.* Such reform will let six or ten institutions collectively have a significant say in corporate affairs, while limiting the power of any one institution to act on its own. I will call this limited role *institutional voice.* Institutional voice means a world in which particular institutions can easily own 5-10% stakes in particular companies, but can't easily own much more than 10%; in which institutions can readily talk to each other and select a minority of a company's board of directors, but can't easily exercise day-to-day control or select a majority of the board.

Id. (footnote omitted).

lihood that these coalitions will be formed and identify the forces that cause such coalitions to fall apart.

The potential, as well as the limits, of shareholder coalitions can be understood only when cooperation is viewed in the shadow of shareholder competition. Shareholders exercising the voice option are the same shareholders as those competing in the capital markets. While cooperation requires the sharing of information, competition requires hoarding it, and if competitors share information at all, they have an incentive to distort it. This section analyzes the potential for forming shareholder coalitions given these constraints. If shareholders are to discipline managers in a meaningful way, they will have to successfully form and sustain such coalitions. However, coalitions of shareholders are usually fragile. Understanding what causes this fragility is important if we are to devise a way to encourage shareholder activism.

A. *Coalition of Proponents*

Large shareholders can cooperate by forming coalitions of proponents who agree to share information and the cost of disciplining managers. Not all shareholders need to cooperate, however. As seen in the discussion of collective action,[141] there usually exists a subgroup which by itself would have an incentive to overcome the collective action problem. Where the amount of the public good received by that subgroup exceeds the cost of providing that good, it would be rational for the subgroup to provide the public good. However, the potential members of this subgroup must agree to cooperate because they themselves face a collective action problem.

The formation of a coalition of proponents depends on a number of factors. One factor is whether at least one shareholder exists who would want to take the initiative in forming the coalition. Such "political entrepreneurs" would help bring the shareholder proponents together and, in addition, may play a role in keeping the coalition together.[142] Another

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[141] *See supra* part III.B.

[142] Political entrepreneurs will usually emerge only if the expected return from acting as an entrepreneur, that is, the sum of the entrepreneur's share of the collective good and any private benefits received by the entrepreneur, exceeds the costs to the entrepreneur of organizing the group. These costs include the cost of identifying, and then communicating with, potential group members, as well as the cost of convincing others to join the group. The political entrepreneur makes certain capital investments in the hope of selling group membership to other potential coalition members. Others will

factor affecting coalition formation is the ease with which shareholders can communicate with each other. The recent changes to the proxy rules were intended to make shareholder cooperation easier.[143] Communication is important because the entrepreneur organizing the group will have to convince potential group members to join the coalition.

1. *Advantages of Coalitions of Proponents*

There are several reasons to encourage formation of coalitions of proponents. First, such coalitions allow shareholders to overcome the collective action problem without requiring very large concentration of shares. Second, as in the case of multiple monitors, multiple proponents acting individually may expend a socially wasteful amount of resources gathering information and making proposals, while a coordinated effort resolves this problem. Third, coalitions allow greater information sharing. Each individual shareholder may possess private information that alone would not lead her to take action. However, the collective information of the coalition members may make it rational for the coalition to take certain disciplining actions. Finally, coalitions will find it easier to make credible threats to managers. This allows coalitions to use other vehicles of shareholder voice, such as direct bargaining with managers.[144]

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join the group only if the cost of joining the group is less than the benefits to be received from being a member of such a coalition. *See* MOE, *supra* note 19, at 37-38.

For a discussion of the role of political entrepreneurs in solving collective action problems, see HARDIN, *supra* note 19, at 35-37; MOE, *supra* note 19, at 36-38; Joel M. Guttman, *Can Political Entrepreneurs Solve the Free-Rider Problem?*, 3 J. ECON. BEHAV. & ORG. 357 (1982); Rock, *supra* note 4, at 465; Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986).

[143] *See* 17 C.F.R. § 240.14a (1994); Regulation of Communication Rules, Exchange Act Release No. 30,147 [1991-92 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 84,903 (Jan. 6, 1992); Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326 [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051 (Oct. 16, 1992); Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071 (1990); Black, *Next Steps in Proxy Reform*, *supra* note 13.

[144] Without this credible threat, it is less likely that management will be willing to negotiate. Repeat players will not be able to fool management over and over again. The other credible threat that institutional investors have—that of exit—becomes less credible with a greater concentration of shareholdings.

2. *Duration of Coalitions of Proponents*

Coalitions of proponents can be formed for just one vote, but ongoing coalitions have greater disciplining effect on managers.[145] Discipline is not a one-time exercise. To be effective, the coalition must pose a constant credible threat of discipline. Even if a coalition falls apart, it may still retain some of its disciplining effect if it is not too costly to put it back together. Furthermore, the coalition does not have to retain the same members; some members may exit. The role of the entrepreneur is to keep the coalition together by attracting new members.

B. Coalition of Voters

A "voting coalition" is a coalition of shareholders that vote against resolutions proposed by managers or in favor of resolutions proposed by shareholder proponents. To be effective, the coalition must comprise at least fifty-one percent of the shares being voted. Shareholders who are not coalition members take a free ride on any increase in corporate value resulting from coalition action. Thus, as with coalitions of proponents, there is a collective action problem in forming voting coalitions.

The benefit of joining the voting coalition is that it increases the probability that the public good will be provided. At first glance, the costs of joining the voting coalition appear minuscule. At a minimum, they include the cost of filling out the proxy card and mailing it back, which is not too great. However, joining a voting coalition is a vote against the status quo as represented by managers. It is easy to speculate that in such a case, a shareholder will be less likely to cast a vote in favor of proponents without getting a better understanding of what she is voting for. As a result, the shareholder will be forced to incur certain costs to learn about the resolutions, including the cost of reading the various proxy statements and of acquiring additional information to verify the information provided in the proxy statements. Where the shareholder believes that these costs are greater than the benefits she will receive, she will either vote with the status quo or not vote at all.

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[145] In other words, ongoing coalitions exert a greater credible threat.

C. *Keeping Coalitions Together Against the Forces of Dissolution*

There are three principal forces which contribute to coalition dissolution or which may prevent coalition formation. The first force stems from the existence of shareholder competition in the capital market, *i.e.*, from competition for information. The second arises out of asset-specific investments that coalition members must make coupled with the threat of coalition defection by other members. The third force is a product of manager-shareholder bargaining.

1. *Shareholder Competition and the Sharing of Information*

The act of shareholder voting requires that shareholders, in one way or another, share information. In other words, in order to form coalitions of voters or coalitions of proponents, some information must be exchanged. One of the theses of this Article is that shareholders have incentives to act strategically when sharing such information, given that they not only act as cooperators when voting on corporate matters, but also as competitors in the capital market. Because of the competition for information in the capital market, shareholders will be reluctant to share information, which if used for the voice process, would help maximize the value of the firm.[146] On certain occasions, shareholders will also have the incentive to distort the information that they share.

a. *Information to be Shared: Coalitions of Proponents*

To form a coalition of proponents, members need to share information. They also need to share the costs of opposing managers, including the cost of information. Information sharing is useful when shareholders are deciding whether to oppose management and during the course of the actual opposition. This includes sharing information about the means of moni-

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[146] *See* Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 63 (1982).

> [T]he existence of an active market for a firm's stock exacerbates the monitoring problem. A shareholder or an experienced monitor whose investigative efforts yield information about managerial misdeeds will almost surely prosper more from immediately selling (or selling short) shares before the market price reflects the firm's trouble than from calling attention to the discovered misbehavior.

Id. (footnote omitted).

toring and disciplining managers and about which proposals to make. While one shareholder acting on the information that she possesses would not find it rational to oppose management, the collective group with its collective information could find it quite rational to do so.

Shareholder proponents also need information from shareholders who are not members of the coalition of proponents, but whose cooperation is needed to form a voting coalition.[147] This includes information on whether those shareholders have already decided to side with proponents. If they have not, proponents will present them with a different view of the world in order to convince the shareholders to side with them.[148] Thus, proponents also need to know what type of information is needed to convince others to join the voting coalition.

Where proponents lack these pieces of information, they will overinvest in the proxy process by trying to convince the converted and those who have already decided to vote with management. In many cases, however, the information cost will exceed the savings from tailoring proxy solicitations solely to reach the undecided. These costs include the costs of gathering, interpreting, and verifying the information. These costs will be reduced as the concentration of shareholding increases because fewer shareholders will be needed to form a successful voting coalition. The lower these costs, the more likely that proponents will succeed.

The proxy rules affect the costs of gathering this information and of convincing others to side with proponents. One of the goals of the proxy provisions of the Securities Exchange Act of 1934[149] was to increase the flow of information to shareholders making proxy decisions. This notwithstanding, until quite recently, the proxy rules made it quite costly for shareholders to communicate with each other.[150] In 1992, the Securities

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[147] The proponent would not want to gather this information from all shareholders but only from those that would help her get the 51% majority needed to win the vote. In many cases it would be too expensive to ascertain this information, but where the subgroup that would be able to overcome the collective action problem is small, the proponent would have to canvass fewer shareholders. She of course would want to contact more than those comprising the minimal subgroup, given that some of those shareholders will decide to vote with management.

[148] One problem with coalitions is that if coalition members have different opinions of the world, each will overinvest in trying to convince the others. *See* HIRSHLEIFER & RILEY, *supra* note 118.

[149] 15 U.S.C. § 78m (1988 & Supp. V 1993).

[150] *See* Black, *Disclosure, supra* note 13.

and Exchange Commission amended the proxy rules to allow greater communication among shareholders.[151]

b. Sharing Information in the Shadow of Competition

As seen above, a market participant can make arbitrage profits if she possesses information not available to the persons with whom she is trading.[152] As a result, a shareholder who possesses information that is not available to the market would not want to impart this information to other market participants, such as other shareholders.

If this information was merely information about the company disclosed by the company, the problem would not be as great because this information usually gets disseminated to the market quite rapidly.[153] However, other types of information, such as information which is not publicly distributed but which is purposely or inadvertently leaked by the company to a few market participants, can affect a company's market valuation.[154] In addition, market participants have different information sets regarding specific companies. These information sets comprise information gathered from publicly available sources, from formal or informal contacts with management, and from other market participants. More importantly, such

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[151] 17 C.F.R. § 240.14a (1994). *See also* Regulation of Communication Rules, Exchange Act Release No. 30,147 [1991-92 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,903 (Jan. 6, 1992); Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326 [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,051 (Oct. 16, 1992). Proxy solicitation firms, by acting as informational intermediaries, help reduce the cost of soliciting shareholders. For a discussion of the role of financial and informational intermediaries in alleviating informational asymmetry problems, see Tim S. Campbell & William A. Kracaw, *Information Production, Market Signalling, and the Theory of Financial Intermediation*, 35 J. FIN. 863 (1980); Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON STUD. 393 (1984); Marcia H. Hillon & Anjan V. Thakor, *Moral Hazard and Information Sharing: A Model of Financial Information Gathering Agencies*, 40 J. FIN. 1403 (1985); Hayne E. Leland & David H. Pyle, *Informational Asymmetries, Financial Structure, and Financial Intermediation*, 32 J. FIN. 371 (1977).

[152] *See supra* notes 90-102 and accompanying text.

[153] The reference here is to information required to be disclosed under the securities laws or otherwise announced to the market by management.

[154] This does not mean that it will not be reflected in the price of the stock. Those market participants who possess the information will bid up the price to a new equilibrium price. The remainder of the market will have to rely on trade decoding or price decoding to try to ascertain the information. *See* Gilson & Kraakman, *supra* note 126, at 572. Such types of decoding will not reveal the complete information to the market, thus, some participants will remain who have a different information set from that of the market, a set they would not be too keen to share with the rest of the market.

sets contain information internally generated by the market participants. In other words, each market participant will process the information available to them in their own way and thus will each have a different probability distribution regarding different future states of the company.[155] Market participants thus will be reluctant to share such information except, of course, for a price, but even then they will have incentives to distort the information shared. This becomes a particular problem in the shareholder voting context.

It is helpful to illustrate the preceding analysis with an example. Assume that we have a publicly traded company. Two of the company's large shareholders, A and B, are thinking of forming a coalition to become involved in management discipline. A and B have each generated their own information sets. Call A's information set X, and call B's information set Y. If A trades using her information set X, she will receive a return of $200, as will B, using information set Y. Thus, A and B receive a total return of $400. Assume however, that if A and B agree to share information they would be able to discipline management through the shareholder voting mechanism and receive a total return of $300. In that case they would be reluctant to share the information because its value from trading would be dissipated and they would each get a greater return from trading individually. They would each get $200 trading individually, as opposed to $150 from using the information collectively for trading.[156]

If, however, the return received from sharing X and Y is $500, then it would make sense for A and B to share their information sets, given that they could each now receive a return of $250, as opposed to only $200, from using the information for trading. Transaction costs must be added, however. In particular, the cost of strategic behavior by A and B must be factored into the calculus. If transaction costs are high enough, for example, greater than $100, then it would not pay for A and B to ascertain whether sharing X and Y will lead to a return of $300 or $500. As a result, where the expected return of sharing X and Y is $500 and the transaction cost is greater than $100, A and B will fail to reach the optimal result.

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[155] *See* Gilson & Kraakman, *supra* note 126, at 594.

[156] For now, assume that the whole trading value of X and Y would be dissipated by sharing that information.

2. *Asset-Specificity and the Threat of Defection*

Shareholders who decide to join a coalition of proponents have to expend resources to acquire and verify information that they would not otherwise acquire. Thus, they will incur costs to acquire information that has a lower value outside of the coalition context, that is, no value or less value than in the capital market context. This is a classic example of asset specificity in the Williamsonian sense.[157] Coalition members will be wary of making such asset-specific investments, especially if they fear that the coalition is not going to last. These investments are a commitment to long-term shareholding; they make exit less likely.[158]

A shareholder making a commitment to stay in a coalition will thus take into account the probability that other coalition members will defect from the coalition by exiting the company. Take, for example, a coalition of five institutional investors, where each investor owns five percent of the outstanding shares. Each coalition member will have an incentive to be the first to defect from the coalition because if any of the other shareholders exits the company, the price of the company's stock will go down.

What we have here is a classic case of the prisoner's dilemma. Each member will find it in her interest to stay in the coalition and incur costs to cause an increase in corporate value. Each member will, however, also want to defect before the others. Thus, each will defect unless they can reach some binding agreement.[159] In this case, defection does not mean that each has an incentive to exit the corporation; what they have is an incentive not to join the coalition, or at least not to make any asset-specific investment.

The prisoner's dilemma problem is exacerbated by the fact that shareholders compete in the capital market. As a result, a coalition member

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[157] *See* WILLIAMSON, *supra* note 68.

[158] On why shareholders would want to maintain their exit options, see Coffee, *supra* note 4.

[159] There are other ways of encouraging cooperation in repeated prisoner's dilemma scenarios. Concerns about reputation play a role in constraining the acts of players in a game, especially among repeat players, those who will be interacting on an ongoing basis. On the importance of reputation, see DAVID M. KREPS, A COURSE IN MICROECONOMIC THEORY 531-544 (1990); Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring 'Contractual Performance*, 89 J. POL. ECON. 615 (1981); Lewis A. Kornhauser, *Reliance, Reputation and Breach of Contract*, 26 J.L. & ECON. 691 (1983). On repeated games, see KREPS, *supra* at 505-15; Kreps et al., *supra* note 134; L. G. Telser, *A Theory of Self Enforcing Agreements*, 53 J. BUS. 27 (1980).

who acquires negative information about the company will not disclose it to other coalition members. Furthermore, she will have an incentive to convince the others that she has no present intention to exit the coalition. This will give her an advantage in the capital market because she can dump her shares before the other shareholders dump theirs.

Recently, commentators have focused on the potential of "relational investing,"[160] which requires long-term commitments by institutional shareholders to remain with a company. Such talk of relational investing would gain credence if these investors made asset-specific investments to show their commitment not to exit the corporation. However, the same prisoner's dilemma problem identified above will exist in making such commitments.

3. Coalitions and Shareholder-Manager Bargaining

As mentioned above, one can view the relationship between shareholders and managers as a bargaining game over certain substantive and procedural stakes.[161] Managers act strategically in order to assure that they retain their jobs[162] and the level of compensation they desire. Coalitions of shareholders formed to discipline managers will obviously encounter management opposition.

It is important then to analyze what weapons managers have available to destabilize coalitions. One such weapon is the threat of retaliation against institutional investors who join a coalition. Managers often make decisions over who is hired to manage the company's pension plans. Furthermore, managers control access to soft information, such as who attends analyst meetings. Managers can also destabilize coalitions by selectively giving information to certain members, either to encourage them to exit

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[160] *See* Gordon, *Institutions As Relational Investors*, *supra* note 4.

[161] *See supra* notes 66-69 and accompanying text. For a more detailed discussion of shareholder-manager bargaining, see Utset, *supra* note 66.

[162] *See* Bebchuk & Kahan, *supra* note 144, at 1100-04 (describing the "ouster-preventive activities," such as trying to increase shareholder support or adopting defensive measures, used by managers facing the threat of a proxy contest); Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1, 47 (1988) ("Management control of the structure and timing of a dual class recapitalization proposal permits strategic behavior vis-a-vis public shareholders.").

the corporation, a form of disguised "greenmail,"[163] or to at least exit the coalition.

The important consideration to note here is history. When managers felt threatened by the rise of takeovers, they lobbied state legislatures for the adoption of antitakeover statutes.[164] They also amended capital structures and adopted antitakeover provisions, such as poison pills, to make it harder for takeovers to succeed. There is no reason to believe that managers have recently adopted a more altruistic stance. As a result, any discussion of the prospects of greater shareholder activism needs to take into account the nature of shareholder-manager bargaining. Changing regulations blindly can only produce disappointment.

VII. Conclusion

This Article addresses the current debate over the rise of shareholder activism. It argues that in evaluating the different calls for changes in federal and state regulations affecting shareholder voice, one needs to have a deeper understanding of the context in which shareholder voice occurs. In particular, the potential of forming shareholder coalitions to discipline managers and the forces that can lead to dissolution of such coalitions are analyzed.

This Article further argues that we need to take into account that shareholders not only act as potential cooperators in disciplining managers, but also that they interact as competitors in the capital markets. Thus, shareholders are involved in two different games, each of which affects the payoffs in the other game. When they interact in the capital market, they compete over information; when they act as cooperators, they need to share that same information. Thus, the formation of coalitions to discipline managers will be greatly hampered.

Interaction in the voice game also affects interactions in the capital market. For example, shareholders bargaining with managers and proponents who know they are about to launch a proxy fight have information that other market participants do not have. Furthermore, commitment to a

[163] This information could be negative information about the company that leads a shareholder to realize that exit is the solution.

[164] These statutes were largely successful in discouraging takeovers. *See* Gordon, *Shareholder Initiative*, *supra* note 4.

voice strategy will often make it harder to adopt the exit strategy. Any attempt to tailor regulations to increase shareholder activism must take these factors into account.

A lot of ink was spilled during the 1980s over the issue of takeover defenses, only to have takeovers disappear as a result of factors such as the power of state legislatures and the fragility of the junk bond markets that were not carefully thought through. Before we go down the same path in the analysis of "relational investing" a little caution and a lot greater understanding would provide a nice first step in avoiding Santayana's oft-quoted warning.